

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9251

RIN 1545-BE71

Special Rules Regarding Certain Section 951 Pro Rata Share Allocations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 951(a) of the Internal Revenue Code (Code) regarding a United States shareholder's pro rata share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, and previously excluded subpart F income withdrawn from foreign base country shipping operations. These regulations are intended to ensure that a CFC's earnings and profits for a taxable year attributable to a section 304 transaction will not be allocated in a manner that results in the avoidance of Federal income tax. These regulations are also intended to ensure that earnings and profits of a CFC are not allocated to certain preferred stock in a manner inconsistent with the economic interest that such stock represents.

DATES: Effective Date: These regulations are effective February 22, 2006.

Applicability Date: For dates of applicability, see §1.951-1(e)(3)(v), (e)(4)(ii) and (e)(7).

FOR FURTHER INFORMATION CONTACT: Jefferson VanderWolk, (202) 622-3810 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On August 6, 2004, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-129771-04, 2004-36 I.R.B. 453) under section 951 of the Code. After consideration of comments received, the proposed regulations were modified and adopted as final with the publication of T.D. 9222 on August 25, 2005 (70 FR 49864). In response to comments, the IRS published at the same time in the Federal Register a notice of proposed rulemaking (REG-129782-05, 70 FR 49894) under section 951 of the Code. No written comments were received in response to that notice of proposed rulemaking. No public hearing was requested or held on the notice of proposed rulemaking. The proposed regulations are adopted as final regulations with the modifications discussed below.

Explanation of Changes

Section 1.951-1(e) defines pro rata share for purposes of section 951(a) of the Code. The general rule, set forth in §1.951-1(e)(3)(i), provides for the allocation of current earnings and profits to different classes of stock on the basis of the respective amounts of such earnings and profits that would be distributed with respect to each class if such earnings and profits were distributed on the last day of the CFC's taxable year on which it is a CFC.

Section 1.951-1(e)(3)(v) provides a special rule that modifies the general rule regarding the allocation of a CFC's current earnings and profits to more than one class of stock. The special rule applies where a CFC has earnings and profits and subpart F income for its taxable year attributable to a transaction described in section 304 of the Code and that transaction is part of a plan a principal purpose of which is to avoid Federal income taxation by allocating the subpart F income resulting from the section 304 transaction disproportionately to a tax-indifferent party. Pursuant to the rule, such earnings and profits are allocated to each class of stock of the CFC in accordance with the value of such class relative to all other classes.

Several practitioners noted in oral comments that proposed §1.951-1(e)(6), Example 9, which illustrates the application of proposed §1.951-1(e)(3)(v), presented facts whose characterization under other Code sections could be unclear under the circumstances. In response to these comments, the IRS and Treasury Department have revised the example in order to limit the issues presented.

A comment on the rules originally proposed on August 6, 2004, requested guidance to eliminate inappropriate distortions between subpart F inclusions and economic realization that taxpayers may achieve if accumulated but unpaid dividends with respect to preferred stock are not discounted to present value for purposes of determining the hypothetical distribution. As a partial response to that comment, proposed §1.951-1(e)(4)(ii) provided a special rule requiring accumulated but unpaid dividends with respect to mandatorily redeemable

cumulative preferred stock be taken into account at present value for purposes of the hypothetical distribution. Comments were requested regarding the treatment of cumulative preferred stock that does not have a mandatory redemption date or that is subject to a shareholder-level agreement, such as a purchase option. In addition, the preamble stated that the IRS and the Treasury Department anticipated that any such rules would be effective for taxable years of a controlled foreign corporation beginning on or after January 1, 2006. No further comments were received beyond the original comment.

The IRS and Treasury Department agree with the commentator that accrued but unpaid dividends generally present possibilities for distortion between subpart F income inclusions and economic income realization. These distortions are similar to those that can arise from stock with discretionary distribution rights. Accordingly, §1.951-1(e)(4)(ii) adds a rule that generally treats cumulative preferred stock with accrued but unpaid dividends in the same manner as stock with discretionary distribution rights (as defined in §1.951-1(e)(3)(ii)). Earnings and profits are allocated to such stock on the basis of the value of such stock relative to the value of other classes of stock outstanding.

There are two exceptions to this general rule. First, to the extent that dividends are paid with respect to such stock during the year, earnings and profits equal to the amount of such dividends are first allocated to that class of stock. Additional earnings and profits are allocated to that class of stock only in the amount (if any) by which the value-based allocation of earnings and profits to that class of stock exceeds the amount of such dividends. Second, the final

regulations preserve the special present-value rule (with technical modifications) for certain mandatorily redeemable cumulative preferred stock.

Consistent with the comment received, and as provided in the preamble to the proposed regulations, these rules are effective for taxable years of a controlled foreign corporation beginning on or after January 1, 2006.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because these regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jeffrey Vinnik of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.951-1 is amended by revising paragraphs (e)(3)(v), (e)(4)(ii), and the first sentence of paragraph (e)(7), and adding paragraph (e)(6) Example 9 .

The revisions and addition read as follows:

§1.951-1 Amounts included in gross income of United States shareholders.

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(e) * * *

(3) * * *

(v) Earnings and profits attributable to certain section 304 transactions.

For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has more than one class of stock outstanding and the corporation has earnings and profits and subpart F income for a taxable year attributable to a transaction described in section 304, and such transaction is part of a plan a principal purpose of which is the avoidance of Federal income taxation, the amount of such earnings and profits allocated to any one class of stock shall be that amount which bears the same ratio to the remainder of such earnings and profits as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the

total value of all shares of all classes of stock of the corporation, determined on the hypothetical distribution date.

(4) * * * (i) * * *

(ii) Certain cumulative preferred stock. For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has one or more classes of preferred stock with cumulative dividend rights, such stock shall be considered for the purposes of this section as stock with discretionary distribution rights. As a result, the provisions of paragraph (e)(3)(ii) of this section shall apply for purposes of allocating earnings and profits to such stock, except that earnings and profits shall first be allocated to the stock under paragraph (e)(3)(i) of this section to the extent of any dividends paid with respect to the stock during the taxable year. Additional earnings and profits will be allocated to the stock only in an amount equal to the excess (if any) of the amount of earnings and profits allocated to the stock under paragraph (e)(3)(ii) of this section over the amount of such dividends. Notwithstanding the foregoing, if a class of redeemable preferred stock with cumulative dividend rights has a mandatory redemption date, and all dividend arrearages with respect to such stock compound at least annually at a rate that is not lower than the applicable Federal rate (as defined in section 1274(d)(1)) (AFR) that applies on the date the stock is issued for the term from such issue date to the mandatory redemption date, based on a comparable compounding assumption, such stock shall not be considered for purposes of this section as stock with discretionary distribution rights.

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(6) * * *

Example 9. (i) Facts. In 2006, FC10, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of common stock and 100 shares of 6-percent, voting, preferred stock with a par value of \$10x per share. All of the common stock is held by Corp H, a foreign corporation, which invested \$1000x in FC10 in exchange for the common stock. All of the preferred stock is held by Corp J, a domestic corporation, which invested \$5000x in FC10 in exchange for the preferred stock. Corp H is unrelated to Corp J. In 2006, FC10 borrows \$3000x from a bank and invests \$5000x in preferred stock issued by FC11, a foreign corporation the common stock of which is owned by Corp J. Corp J's adjusted basis in its FC 11 common stock is \$5000x. FC11, which has no current or accumulated earnings and profits, distributes the \$5000x to Corp J. Subsequently, in 2007, FC10 sells the FC11 preferred stock to FC12, a wholly-owned foreign subsidiary of FC11 that has \$5000x of accumulated earnings and profits, for \$5000x in a transaction described in section 304. FC10 repays the bank loan in full. For 2007, FC10 has \$5000x of earnings and profits, all of which is subpart F income attributable to a section 304 dividend arising from FC10's sale of the FC11 preferred stock to FC12. At all relevant times, the value of the common stock of FC10 is \$1000x and the value of the preferred stock of FC10 is \$5000x.

(ii) Analysis. The acquisition and sale of the FC11 preferred stock by FC10 was part of a plan a principal purpose of which was the avoidance of Federal income tax by depleting the earnings and profits of FC12 and allowing FC11 to make a distribution to Corp J that it characterizes entirely as a return of basis. FC10 has \$5000x of earnings and profits for 2007 attributable to a dividend from a section 304 transaction which was part of such plan. Under paragraph (e)(3)(v) of this section, these earnings and profits are allocated to the common and preferred stock of FC10 in accordance with the relative value of each class of stock (\$1000x and \$5000x, respectively). Thus, for taxable year 2007, \$833x ($1/6 \times \$5000x = \$833x$) of these earnings and profits is allocated to FC10's common stock and \$4167x ($5/6 \times \$5000x = \$4167x$) is allocated to its preferred stock.

(7) Effective dates. Except as provided in paragraphs (e)(3)(v) and (e)(4)(ii) of this section, this paragraph (e) applies for taxable years of a controlled foreign corporation beginning on or after January 1, 2005. * * *

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/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: February 8, 2006

/s/ Eric Solomon

Acting Deputy Assistant Secretary of the Treasury (Tax Policy).